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THE DIRECTOR OF CENTRAL INTELLIGENCE

WASHINGTON, D.C. 20505

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National Intelligence Council

MEMORANDUM FOR: W. Allen Wallis
Under Secretary for Economic Affairs
Department of State

FROM: Maurice C. Ernst
NIO for Economics

SUBJECT: Follow-up on the "Non-Paper"

1. To follow up on the conversation [redacted] I had with you and your staff on East-West economic relations, I have tried to put some of my personal thoughts and concerns to paper. Since our meeting, I have also met with Tom Niles and his staff. I believe we are agreed on how to approach the overall NATO study on the strategic implications of East-West economic relations, how the ECONAD work plan can be adjusted to support this study, and what CIA can do to help.

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2. I believe there are reasonable chances of making progress in achieving more effective controls over Allied economic relations with the USSR in two areas: military-related products and technologies, and alternative energy sources. There could also be some progress in reducing interest subsidies, but the difficulties are great and the impact small. Broader studies on the strategic implications of East-West relations could improve communications with our Allies, and facilitate other measures, but almost certainly not lead directly to definite commitments.

COCOM, etc.

3. Although the Allies claim to share our objective of denying militarily-related goods and technology to the USSR, they have accepted only narrow criteria and put the burden of proof on the United States. In COCOM, the criteria for denial have been quite strict--a unique, substantial, and demonstrable impact on Soviet weapons systems and military programs. These criteria are very demanding of information and tend to eliminate most dual use items from consideration.

4. I believe an effective case can be made for substantially broader export control criteria that would cover not only direct inputs for military industries, but also those which contribute to development of

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industries essential to military production or the output of which goes in large part for military use. In addition, there should be a systematic look at technologies which can facilitate development of future weapons systems. The purpose of the controls would be both to impede Soviet military development and modernization, and to avoid some of the large military expenditures Western countries must make to keep up with the Soviets.

5. The kind of work needed to expand export controls is difficult and time-consuming. Modern weapons systems use a great many different technologies and their development permits many design options. It is extremely difficult to find instances in which Western technologies are demonstrably critical to the system as a whole. Even so, substantial progress is possible if a systematic, long-term effort is made on individual industries and weapons systems.

6. Apart from dual use items, there is virtually no chance of agreement on controls over oil and gas equipment and technology. The only "unique" aspect of these exports is their exceptionally large impact on Soviet foreign exchange earnings. But it is difficult to make this a criterion for controls, given our Allies' generally positive view of the economic and political impact of East-West trade (see below).

Alternative Energy

7. With respect to alternative energy, a good start has been made, but the specific factors governing development and sale of Norwegian gas have not yet been tackled. Changing Norwegian development plans substantially will be difficult, and the cost of Norwegian gas is likely to be high, but at least the Europeans appear to share our concern about increasing their dependence on Soviet gas sources, so there is a basis for progress.

8. The main use of the IEA/OECD studies will be to make the Europeans more aware of the potential for a substantial increase in dependence on Soviet gas. The studies also should help to focus attention both on possible means of minimizing the impact of supply disruptions and on alternative gas sources.

9. The difficult part will be to determine exactly what are the specific technical, legal, administrative, and political factors which determine Norwegian gas policies, and how these factors mesh. Until we have a great deal more information on these questions, it will be impossible to determine specifically what we would like the Norwegians to do, which possible steps might conceivably be acceptable to the Norwegians, what kinds of complementary actions would need to be taken by other countries, and perhaps what sweeteners might have to be provided. There is little chance of completing such a study before the next Economic Summit, but perhaps a start can be made. This will require a rather

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intensive consultation and collection effort and possibly use of a well-connected external contractor.

Credits

10. With respect to achieving an agreement to reduce or eliminate interest subsidies on credits, there are three interrelated problems: Soviet internal accounting; lack of transparency of Western credit terms; and differences in trade policy.

11. The French claim that the Soviets convert foreign credit transactions into domestic rubles by applying the official exchange rates at the time of the contract to the nominal interest rates. This means that the borrowing enterprise has to make larger repayments the higher the nominal interest rate--a practice that favors DM or yen loans over French franc loans even at market rates of interest because of the inability of the Soviet accounting system to handle exchange rate expectations. There is some corroborating evidence for the French claim, but we are not sure, and are studying the matter further. If the French are right, a conceivable solution to this problem would be to express all loans to the USSR in terms of rubles as a numeraire.

12. But any agreement along the above lines requires transparency as to the terms of Western loans. Unfortunately, several Western countries, especially Germany and Japan, regularly charge the Soviets below market interest rates but claim to offset this through higher export prices. Obviously this practice, if continued, would prevent any sort of effective interest rate agreement.

13. Even if these two barriers were surmounted, some countries would be inclined to continue using interest subsidies to maintain their market shares during periods when an overvalued currency had weakened their competitive position. The French have been particularly guilty of this practice and, in addition, seem to give a high priority to reducing their large deficit on bilateral trade to the USSR.

14. These barriers make it highly unlikely that much progress can be made on this front. The chances of progress are probably better if we do not treat the French as if they were the only sinners. German practices may be just as troublesome. Moreover, all governments except the US provide credit guarantees and in this international climate, these are indeed a form of subsidization. Without such guarantees, Moscow would have little chance of obtaining any long-term credit, and East European countries no chance at all.

The Broad Strategic Impact of East-West Trade

15. We have an excellent opportunity to engage in serious discussions with our Allies on the strategic aspects of East-West economic relations.

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This broad issue raises such fundamental questions as:

- o How severe are the USSR's economic problems? To what extent do these problems constrain Moscow's military and foreign policy choices? And what kinds of interactions can we expect between economic pressures and Soviet domestic politics?
- o How and to what extent does the USSR use economic relations with the West to expand its military power?
- o How and to what extent can Western economic actions influence Soviet domestic and foreign policies?
- o How is Eastern Europe likely to be affected by the policy interactions of the West and the USSR? How limited are its own options to deal with economic problems?
- o How can expanded East-West trade increase Western vulnerability to Soviet actions?

16. Given the general West European view of East-West economic relations not only as bringing economic benefits, but also as constituting a stabilizing element in political relations with the East, it is highly unlikely that discussions of these broad topics will lead to specific control actions. They can, however, lead to better inter-Allied consultations and facilitate agreement in particular areas on which joint studies will be conducted. Moreover, they could lead to an exchange of views on large East-West economic projects, such as the gas pipeline, and other possible sources of major public issues and irritants.

17. Our Allies will not be persuaded by, indeed will respond adversely to, a US argument that shortfalls in Soviet foreign exchange earnings will directly impact on military and foreign policy programs.

[redacted]

[redacted]

argument at all. Obviously, the Soviets will continue to import the highest priority goods, which presumably include those with important military uses, even when short of foreign exchange. A legitimate and more persuasive argument on the foreign exchange shortfalls is that Moscow is unable to completely insulate its military programs from any major shortfall in key economic inputs, including foreign exchange for several reasons:

- o The Soviets may choose to cut military programs of lowest priority in order to ease the impact on economic growth. Foreign policy expenditures, such as aid to countries like Viet Nam or Angola, probably are particularly vulnerable to cuts because they are unpopular in the USSR.

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- o The cuts in foreign exchange allocations may cause unplanned reductions in military production because of the complexity of economic repercussions, especially in a period when shortages are already prevalent.
- o In a bureaucratic environment it is difficult to allocate shortfalls efficiently; the tendency is to exempt some obviously high priority programs and cut all the rest proportionately. Military programs can be affected along the way.

Organizational Issues

18. None of the three organizations charged with the East-West "studies"--the OECD, NATO, and COCOM--are adequately organized to deal effectively with the issues and the links between them are poor or nonexistent.

19. The OECD is in the best shape, with a small but competent staff and a tradition of discipline in economic and statistical analysis. The energy work in the IEA is particularly strong and the OECD can build on it. The quality of the work on East-West trade and finance has been generally good, but this work has been treated as a highly subordinate element of the OECD's responsibility for international trade and finance. A higher level focal point for organizing East-West work is needed within the OECD.

20. Unfortunately, the NATO Economic Committee has been a relatively low-level organization responsible mainly for background studies and the NATO Economic staff is small, not very competent, and in the past has had weak leadership. Moreover, the NATO bureaucracy makes it extremely difficult to cross Committee lines on a cooperative basis. Since the NATO Economic staff cannot be upgraded quickly enough for the current exercise, it may be necessary for member countries to assign competent senior analysts to the staff to help write the key study. Moreover, for the study to be useful it will have to go well beyond the Economic Committee's normal area, and delve into political and military matters. Alternatively, some sort of joint working group would have to be set up.

21. The USG has been seeking changes in the COCOM organization to facilitate broader assessments and bring Allied military organizations more into the action. If these attempts are not successful, it might be possible to use the NATO military and economic work to help pave the way for expanded COCOM controls, a kind of back door to COCOM.



✓ Maurice C. Ernst

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